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July 14, 1999



**CITY OF
ESCONDIDO**
201 NORTH BROADWAY
ESCONDIDO, CA 92025

Honorable Wayne L. Peterson
Presiding Judge of the Superior Court
220 W. Broadway
San Diego, CA 92101-3888

Re: San Diego Grand Jury 1998-1999 Report:
"Financial Reporting by the City of Escondido's
California Center for the Arts"

Dear Honorable Wayne L. Peterson:

Pursuant to California Penal Code section 933(c), this correspondence is provided by the City of Escondido and the California Center for the Arts Escondido Foundation (hereafter "CCAE") in response to the San Diego Grand Jury 1998-1999 Report entitled "Financial Reporting by the City of Escondido's California Center for the Arts." By way of background, both the City and the CCAE received a copy of the Grand Jury's Report on April 26, 1999. Pursuant to the Grand Jury's request and Penal Code section 933.05(f), the City and the CCAE did not disclose the contents of the report until Wednesday, April 28, 1999, the date the report was filed with the County Clerk and released to the public.

FINDINGS

The following comments to the Grand Jury's findings are made on behalf of John Haynes, the Chief Executive Officer of the California Center for the Arts, Escondido Foundation, Inc., Vicky Baseshore, Financial Vice President, California Center for the Arts, Escondido Foundation, Inc., and the Escondido City Council.

Finding No. 1: It appears that financial information published in the newspaper was obtained from interviews either by phone or in person with "officials" of the Center or the City. Financial press releases were never issued to the media by the Chief Financial Officer or by the Chief Executive Officer of the Center. Nor were any such communications to the media made by the Mayor's Office, the City Finance Director, or the City Attorney relative to the results of operations of the Center. The reporter covering the Center for the *San Diego Union-Tribune* has been doing so from the time the Center opened to this date.

Lori Holt Pfeiler, Mayor
Keith E. Beier, Mayor Pro Tem
Jerry Kaufman
June Rady
Marie Waldron

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Therefore, there can be no claim that the covering reporter was not familiar with the Center's operations.

Response: Respondents disagree partially with this finding, but the last two sentences of this finding are disputed because while the reporter in question, Erik Bratt, may have been covering the Center from its inception, this is no guarantee that he understood non-profit accounting and finance issues. In fact, Mr. Bratt routinely misquoted or misconstrued Mr. Haynes' comments.

Finding No. 2: At public meetings held by the marketing department of the Center, with representatives of the press present, numbers were announced that were supposed to inform the public of the results of operations of the Center. The information given at these meetings was based on projections made on a cash basis and gave no effect to non-cash expenses such as depreciation, discarded equipment, amortization of deferred prepaid start-up expenses, vacation accruals etc.

Response: Respondents agree with this finding.

Finding No. 3: On June 27, 1995 in an article in *The San Diego Union-Tribune* headlined "Center for Arts Ends First Year in Black" it was reported that "the ... Center ... will end its inaugural year with a balanced budget." The final audited financial statement showed an operating loss of \$1,484,730 for the period.

Response: Respondents agree with this finding.

Finding No. 4: On July 25, 1996 an article for *The San Diego Union-Tribune* stated "the Center is coming off a difficult season. For the year ended June 30, it incurred a loss of \$826,000." The final audited financial statement showed an operating loss of \$1,525,475 for the period.

Response: Respondents agree with this finding.

It is worth noting that it was at this point that the prior CCAE non profit decided they were unable to manage the Center. The management was handed back to the City, the former Executive Director resigned, the Wolf Organization was brought in to do an assessment and a new management organization and business plan were put in place. Many of the problems in financial management that had occurred were corrected as a result of the reorganization, and were most associated with the previous administration.

Finding No. 5: On July 16, 1997 an article in *The San Diego Union-Tribune* stated "the shortfall may be around \$105,000, according to city officials. This compares with a \$1.5 million shortfall last year." The final audited financial statement showed an operating loss of \$427,670 for the period. Note that the reference to prior year's results as a comparative reflect the audited figure not the figure originally reported in the newspaper as the results of operations for that year.

Response: Respondents agree with this finding.

Finding No. 6: Variances of hundreds of thousands of dollars between announced figures and final audited financial statements tend to create doubt and skepticism, undermining public confidence in the financial operation of the Center.

Response: Respondents agree with this finding.

Finding No. 7: When the newspapers printed the financial results of operations, there was no mention of the City's subsidies and its impact on the reported financial results. The following is a summary of the subsidies' effect on the operating results, in dollars.

<u>Fiscal Year</u>	<u>Final Audited Results</u>	<u>City Subsidy</u>	<u>Before Subsidy</u>
1993	(16,602)	385,000	(401,602)
1994	(168,899)	400,000	(568,899)
1995	(1,484,730)	370,000	(1,854,730)
1996	(1,525,475)	1,656,073	(3,181,548)
1997	(427,670)	1,589,779	(2,017,449)
1998	(444,011)	<u>1,589,000</u>	(2,033,011)
		<u>5,989,852</u>	

Response: Respondents disagree partially with this finding. Respondents agree with the amounts listed in this finding. However, Respondents disagree with the finding that *no* newspapers reported the City's subsidies. This may have been true of the *San Diego Union Tribune*, but contemporaneous reports in the *North County Times* made regular mention of the City's subsidies and of the debt forgiveness mentioned in Finding No. 8. Respondents have serious concerns if the Grand Jury's entire investigation and report is based entirely on articles of a single reporter in a single newspaper. Respondent John Haynes was informed by the editor of the *North County Times* that no attempt was made by the investigator for the Grand Jury to review *North County Times'* reports on Center finances. Additionally, the six year summary of City subsidies and their effect on Center deficits presented in this finding has always been readily available and clearly identified in all of the Center's audited financial statements, complete with footnotes, which were made available to both the press and the general public.

Finding No. 8: In addition to the above referenced subsidies of almost \$6,000,000 there was a forgiveness of debt, as detailed in the Facts section of this report, totaling \$2,977,626. The aggregate of the subsidy the Center has received from the City is almost \$9,000,000 without any weight being given to the interest applicable to the forgiven principal.

Response: Respondents disagree partially with this finding. The City provided approximately \$2.4 million in start-up costs from a fund originally intended as an endowment which has not been included in this calculation. Accordingly, City's funding is closer to \$11.4 million, not \$9 million as stated in this finding. Further, the Grand Jury's report is presented in a manner that

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makes City investments appear secretive and contrary to the public interest. To the contrary, all City investments were public policy decisions made by the elected representatives of the taxpayers of Escondido.

RECOMMENDATIONS

The following comments to the Grand Jury's recommendations are made on behalf of John Haynes, the Chief Executive Officer of the California Center for the Arts, Escondido Foundation, Inc., Vicky Baseshore, Financial Vice President, California Center for the Arts, Escondido Foundation, Inc., and the Escondido City Council.

Recommendation No. 99-34: The Financial Vice President of the Center should ensure that interim and year-end financial reporting is accurate and timely and conforms to the format of the financial statements submitted to independent certified public accountants for the purpose of the annual audit.

Response: This recommendation has been implemented. The interim and annual statements have been accurate and timely in the past and will continue to be.

Recommendation No. 99-35: The Financial Vice President of the Center should ensure that budgets and financial projections include non-cash items such as depreciation, amortization of deferred expenses, accrued vacation, etc. in order to conform with the format of the financial statements submitted to independent public accountants for the purpose of the annual audit.

Response: This recommendation has not yet been implemented, but will be implemented in the future. Specifically, beginning with year-end financial statements following the close of the fiscal year ending June 30, 1999, California Center for the Arts, Escondido Foundation will release to the press and public only budgets and financial statements that contain estimates for depreciation and other non-cash expenses.

Further, it is common practice to construct operating budgets without including non-cash expenses such as depreciation and amortization, since departmental managers have no control over these elements and the real test of the organization's health is liquidity. Typically, they are booked in the twelfth month of the fiscal year. Budgets and interim reports are management tools, not formal statements of the organization's financial condition and the two must not be confused. California Center for the Arts Escondido Foundation will *not* be responsible for any conclusion drawn from an internal management report that has not been constructed as a formal statement of financial position.

Just as the absence of non-cash expenses from budgets and interim reports can produce a variance between the expectations they raise and the final audited result, so too can non-cash income. FASB regulations require that non-profits book any number of income items as current revenue that may not, in fact, produce cash in the current period. Multi-year pledges of

operating grants, for example, must be booked as income in the year in which the pledge is received, even though hundreds of thousands of dollars of that income may not be available for operations for several years.

The cumulative effect of numerous non-cash income and expense entries - most of which are unique to non-profit accounting - is to create an environment in which formal statements of financial position are not useful as management tools. It is simply not possible to know - and foolish to speculate - about the effect of pledges that have yet to be made. They will, however, have a material effect on subsequent financial statements when they are booked. It is not uncommon for a non-profit to look healthy on paper and have serious cash flow problems.

Recommendation No. 99-36: The Chief Executive Officer of the Center should establish a regular, predictable communication schedule between the Center and the public for the dissemination of financial information on a consistent basis.

Response: This recommendation has not yet been implemented but will be implemented in the future. Common practice nationwide is for cultural non-profits to release financial reports only after the annual audit is complete, at which time the auditor's report and a copy of the organization's tax returns are made available to the press and public. Many institutions also publish an annual report.

It is the intention of John Haynes, Chief Executive Officer of the California Center for the Arts, Escondido Foundation, Inc. to release *quarterly* interim financial statements to the press and to answer their questions about the Center's financial performance. In addition, Respondent Haynes currently meets with reporters in his office every month on the morning following the meeting of the Board of Trustees, at which time he reports the programmatic activities of the Center and answers their questions. He will use this opportunity once a quarter to issue an interim financial statement which will clearly indicate the amount of any City subsidy, projected depreciation expense and other material fiscal entries. No other report of the Center's financial affairs should be taken to be a representation of the Center's management or Board.

Recommendation No. 99-37: The Chief Executive Officer of the Center should ensure that formal press releases be issued indicating results of operations and clearly indicating the amount of any and all subsidies by the City, including extraordinary items such as forgiveness of indebtedness as well as direct cash contributions.

Response: This recommendation will not be implemented because it is not warranted nor reasonable, since formal press releases are duplicative of the actual financial statements presented in the context of Recommendation No. 99-36. Such statements contain operating results and the City's subsidies and other contributions are listed as discrete line items. To single out the City's subsidies as the topic for a formal press release ignores many other sources of public and private funding. Most non-profit arts organizations the size of CCAE receive some combination of federal, state, county and municipal funding, in addition to substantial sums from

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corporations, foundations and individuals. The press is free to report the City's investment in the operations of the Center and has free and open access to both Council meetings and Center financial reports in order to do so.

Recommendation No. 99-38: The Chief Executive Officer of the Center should advise all senior executives, department heads, and board members that telephone interviews and marketing news conferences should not be venues for discussing the financial operations of the Center. There must be only one spokesman for the Center and that should be the Chief Executive Officer.

Response: This recommendation has been implemented. No person other than the President and CEO is authorized to speak on behalf of the Center with respect to fiscal matters.

Recommendation No. 99-39: The Chief Executive Officer of the Center should ensure that copies of the year-end audited financial reports are available to the general public by inclusion in one of the many mailers distributed by the Center during the year. Copies of the report should be made available to the Escondido Public Library for inclusion in their archive. A copy of the report should be published on the city's web site. Copies should be available, for the asking, at the Center and at City Hall.

Response: This recommendation has not yet been implemented, but will be implemented in the future with some modification as to methodology.

This recommendation is intended to make the Center's audited financial statements easily available to the general public. The law currently requires that non-profits organized under section 501c(3) make both audited financial statements and copies of tax returns available to the public at their places of business upon request. This recommendation imposes a positive obligation on the institution to see to it that every member of the public receives their personal copy. To mail copies of the annual audit as suggested in this finding is impractical for two reasons. First, the expense would be prohibitive and unwarranted. Secondly, Center mailers do not go to *every taxpayer in Escondido*, presumably the audience this recommendation has in mind, but instead mailers go to specific, targeted audiences.

In light of the foregoing, effective immediately, Respondents will do as follows:

- Continue to comply with state and federal regulations regarding public access to information.
- Comply with any new recommendations with respect to public information that may be made by recognized non-profit oversight groups such as the National Council on Non Profit Boards.
- Make a copy of the annual audit available to the City of Escondido for public review at City Hall.
- Provide the Escondido Public Library with a copy of the annual audit for their archive.

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- Publish a copy of the annual audit on the Center's website for a period of at least 90 days subsequent to its acceptance by the Board of Trustees.

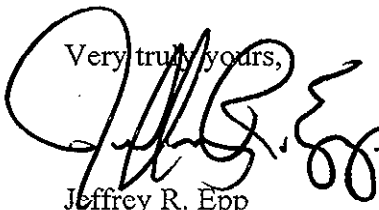
The goal of public information is to make it available and easily accessible to any interested party. Respondents believe that these steps, in conjunction with quarterly press briefings, constitute unprecedented public access.

Recommendation No. 99-40: The Financial Vice President of the Center should ensure that financial information released to the media will not have a material variation from the audited annual financial statements.

Response: This recommendation has been implemented.

Recommendation No. 99-41: The Escondido City Council should endorse, authorize, and encourage the implementation of these recommendations.

Response: This recommendation has been implemented by unanimous vote of the City Council on May 12, 1999.

Very truly yours,

Jeffrey R. Epp
City Attorney

JKM:jk

ccae/gjresponse.doc

cc: City Council
John Haynes, Chief Executive Officer, CCAEF
Rolf Gunnarson, City Manager